SUGAR AND COFFEE AGREEMENTS

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL TRADE

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

S. 2539 and S. 2540

JULY 28, 1982

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SUGAR AND COFFEE AGREEMENTS

WEDNESDAY, JULY 28, 1982

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON INTERNATIONAL TRADE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9 a.m. in room 2221, Dirksen Senate Office Building, Hon. John C. Danforth (chairman of the subcommittee) chairing.

Present: Senator Danforth.

[The committee press release and the prepared statements of Senators Dole and Baucus follow:]

[Press release of July 12, 1982]

FINANCE SUBCOMMITTEE ON INTERNATIONAL TRADE SETS HEARING ON BILLS IMPLEMENTING COFFEE AND SUGAR AGREEMENTS

The Honorable John C. Danforth (R., Mo.), chairman of the Subcommittee on International Trade of the Committee on Finance, today announced that the Subcommittee will hold a hearing on Wednesday, July 28, 1982 on two bills which would extend the legislation implementing the International Sugar Agreement and the International Coffee Agreement. Chairman Danforth stated that testimony will be received from both administration and private witnesses.

The hearing will begin at 9:30 a.m. in Room 2221 of the Dirksen Senate Office Building.

The two bills on which testimony will be received are:

S. 2539 introduced by Senator Danforth. S. 2539 would amend the International Sugar Agreement Act (P.L. 96-236) by extending the termination date of the Act from January 1, 1983 to January 1, 1985.

S. 2540 introduced by Senator Danforth. S. 2540 would amend the International Coffee Agreement Act (P.L. 96-599) by extending the termination date of the Act from October 1, 1982 to October 1, 1983.

Consolidated testimony.—Senator Danforth urges all witnesses who have a common position or who have the same general interest to consolidate their testimony and designate a single spokesman to present their common viewpoint orally to the subcommittee. This procedure will enable the subcommittee to receive a wider expression of views than they might otherwise obtain. Senator Danforth urges that all witnesses exert a maximum effort to consolidate and coordinate their statements.

OPENING STATEMENT OF SENATOR ROBERT DOLE

Mr. Chairman, today the subcommittee will be considering two bills, S. 2539 and S. 2540, which would extend the public laws implementing the International Sugar Agreement and the International Coffee Agreement. These agreements, which the Senate previously approved, are both designed to stabilize world prices, within mutually agreed upon price ranges, by controlling the supplies of the two commodities available in world trade. As the largest free market in the world for both commodities, it is critical to the effectiveness of these agreements that the U.S. be able to implement their provisions.

Under both agreements, producing countries agree to stockpile assigned quantities of coffee or sugar when prices are falling and then to release designated quanti-

ties of coffee or sugar from these stockpiles when prices are rising within the established increments. In order to keep any exporting country from shipping more than its assigned amount when quantitative restrictions are in effect, the signatories to the agreements have committed to denying entry to any imports not accompanied by proper documentation or to prohibit the entry of imports from nonsignatories. Currently, the administration is authorized to control the entry of imports in accord with the provisions of the agreements. This authority expires at the end of this year, however, and must be extended if the U.S. is to continue to be able to implement the agreements.

Mr. Chairman, it is my understanding that to date no one has voiced opposition to the bills which you have introduced and it is my hope that we will be able to proceed with them if this remains the case.

STATEMENT OF SENATOR MAX BAUCUS

Mr. Chairman, I am pleased that the Subcommittee is holding hearings on S. 2539, which extends current law implementing the International Sugar Agreement.

I am particularly interested in authorizing the President to regulate the entry of sugar into the United States. The International Sugar Agreement should be extended for two reasons:

1. To keep the ISA cohesive and meaningful, we must be able to impose limits on the entry of sugar from countries that are not ISA members.

2. To help stabilize the price in the domestic sugar industry.

The domestic sugar industry now holds only 45 percent of the U.S. market share—and this figure is declining. Many mills and refineries did not survive the period of volatile sugar prices experienced by the U.S. industry over the past several years.

In late 1974, world raw sugar prices hit 65 cents per pound. In 1978, the market collapsed and the world price fell to 7 cents. By 1980, the price recovered to 42 cents until today—when the price again sags below 10 cents.

In my home state of Montana, last year's sugar beet campaign yielded over $45 million in cash value. But, sagging prices threatened to drive producers out of the sugar industry.

The renewal of the ISA combined with an adequate domestic sugar stabilization program will assure that the domestic industry remains healthy.

I would ask Ambassador MacDonald at this point if it is not true that maintaining a healthy domestic sugar industry is important not only for U.S. producers, but for consumers as well. If domestic sugar supplies disappear, would we see an increase in sugar prices?

Will the Administration strongly support the current sugar support level of 17 cents—which is below the world-wide average cost of production and almost half of the U.S. cost of production?

Senator DANFORTH. The subject of this hearing is the extension of the coffee and sugar agreements, and the witness is Ambassador MacDonald. Ambassador, thank you.

STATEMENT OF AMBASSADOR DAVID R. MacDONALD, DEPUTY U.S. TRADE REPRESENTATIVE

Ambassador MACDONALD. Mr. Chairman, I would like to express Ambassador Brock's appreciation to you for holding these hearings on two important pieces of legislation to particular industries. We are here to speak on behalf of the administration in support of Senate bills 2539 and 2540. I have a full statement, Mr. Chairman, and a four-page summary.

Senator DANFORTH. The statement will be printed in full in the record.

Ambassador MACDONALD. Thank you. Both bills extend the life of legislation that allows the United States to implement the International Sugar Agreement and the International Coffee Agreement.

S. 2540 will enable the United States to continue to fulfill its obligations under the coffee agreement for an additional 1-year period. Specifically, the legislation allows the President to regulate the entry of coffee into the United States by not allowing coffee from International Coffee Association members which is not accompanied by the proper documentation to enter the United States. The President is also authorized to restrict coffee imported into the United States from countries which are not members of the ICA.

The United States, along with all other ICA members, is participating in the negotiations for a new agreement, one that will be an improvement over the current ICA. Specifically, these negotiations are related to an amendment to the agreement which provides for the prohibition of restrictive arrangements among coffee suppliers, as occurred under the old coffee agreement. It would also change the means by which the mix of different types of coffee are determined under the coffee agreement to be exportable.

Assuming these negotiations are successfully concluded this September, the United States will agree to continue to participate in the ICA throughout the extension year. This extension year will give the United States and other ICA members time to complete the parliamentary procedures needed to bring a new agreement into force. For the United States, this will entail Senate ratification of a new treaty and congressional passage of new implementing legislation.

The National Coffee Association, which represents a large segment of the U.S. industry, has indicated that as long as the Government believes that the ICA is in the best interests of the United States, it can accept and support the agreement. Various segments of the industry have cited the need for market stability and believe that the ICA is the best means of achieving this objective.

I would like to reiterate the need to take quick action on this bill. It is imperative that we have new legislation in place by October 1, 1982, in order to be able to comply with our treaty obligations. Our failure to do so could disrupt the world coffee market significantly, to the detriment of producers and consumers and of our relations with the coffee-producing countries of the world.

S. 2539 will extend the legislation implementing the International Sugar Agreement for 2 years, until December 31, 1984. This legislation gives the President authority to continue to assure that imports of sugar into the United States are accompanied by the proper documentation and that import restrictions on non-International Sugar Organization members are enforced.

The 2-year extension period will allow time for renegotiation of the ISA, as well as for completion of parliamentary procedures needed to bring it into force.

While we recognize that the nonmembership of the European Community has proved difficult to operate the economic provisions of the International Sugar Agreement, the administration supports our continued participation in the agreement. The 2-year extension will allow time for continued consultations between the International Sugar Organization and the EC. These consultations are meant to pave the way for EC accession to the current agreement or participation in a new agreement.

Despite its shaky performance, the ISA has been marginally successful in reducing price volatility in the face of conditions of both substantial surplus and shortage.

It would be worthwhile to take note of recent actions taken by our own Government in response to current instability in the world sugar economy. In May the President made a decision to impose temporary quotas on sugar imported into the United States. This action was necessitated by the declining world price, with duties and fees alone.

As a result, we have been asked by ISA exporting members to explain our quota program, and we have carried out useful discussions to this effect in London.

We believe it is also important that we reaffirm our commitment to working in the ISA to help address the problems of both the world sugar economy in general, as well as those of individual sugar-exporting countries in Latin America and other regions of the world where we have an important stake in economic and social stability.

We urge that S. 2539 be passed quickly. Such action will positively signal our continued support of multilateral efforts in this direction. The ISA will not increase U.S. consumer prices for sugar. On the other hand, our failure to meet our treaty obligations under the agreement would tend to put further downward pressure on the already troubled world market for sugar, and could result in the imposition of even more restrictive measures on sugar imports.

Thank you, Mr. Chairman.

[The statement of Ambassador MacDonald follows:]

STATEMENT OF AMBASSADOR DAVID R. MACDONALD, DEPUTY U.S. TRADE REPRESENTATIVE

I am Ambassador David R. MacDonald, Deputy United States Trade Representative. I am here to speak on behalf of the administration in support of S. 2539 and S. 2540. Both are bills to extend the life of the legislation that allows the United States to implement the International Coffee Agreement (ICA) and International Sugar Agreement (ISA).

The ICA was due to expire on September 30, 1982. A resolution, supported by the United States, was passed by the international coffee organization calling for an extension of the agreement for one year to September 30, 1983. The extension is conditioned by a proviso that proposals for modification to the agreement beyond October 1, 1983, shall be decided upon prior to September 17, 1982. This proviso results from the consumer interest in improving the ICA through modifications of the economic provisions. In order to continue to carry out its obligations under the ICA during the one-year extension period (September 30, 1982, to September 30, 1983), the administration is seeking passage of S. 2540.

Negotiations for modification of the ICA are ongoing. In negotiating modifications of the ICA, the United States has sought to improve the system for distributing the total quota among exporting members. Another important U.S. objective is inclusion in a new agreement of a provision that would prohibit exporters from undertaking collusive marketing activities outside the terms of the coffee agreement. Assuming these negotiations are successfully concluded by mid-September, the United States will agree to the extension year. The extension year will give the United States and other ICA members time to complete parliamentary procedures needed to bring a new agreement into force. For the United States, this will mean Senate ratification of a new treaty and congressional passage of new implementing legislation.

The implementing legislation which we seek enables the United States to continue to fulfill its obligations under the ICA. Specifically, this means that the President is authorized to regulate the entry of coffee into the United States by not allowing coffee from ICA members which is not accompanied by the proper documentation to enter the United States. The President is also authorized to restrict coffee imported into the United States from countries which are not members of the ICA.

The current ICA entered into force on October 1, 1976. All major producing countries and most major consuming countries are members. The United States has participated in a series of coffee agreements dating back to 1962.

The agreement seeks to assure a reasonable balance between world demand and supply of coffee and to assure fair prices to consumers and remunerative prices to producers. The agreement relies on export quotas to stabilize prices within an annually negotiated price range. Quotas are enforced by importing members by controls on imports.

Quotas are adjusted at specified levels within the current price range of $1.15 to $1.45 per pound. Quotas are tightened—thus reducing the available world supply of coffee—as prices fall. At the lower end of the range, the most restrictive quota is in effect. If prices rise to the upper end of the range, quotas are gradually increased. Quotas are removed (and ICA members may export without restriction) if prices exceed $1.50. When quotas are in effect, the world quota is divided among all the exporting members of the ICA which currently includes almost 100 percent of the coffee producing countries.

Between 1976 and mid-1980, the economic provisions of the agreement remained suspended. This was because of high coffee prices, which resulted from frosts in Brazil and supply disruptions in other exporting countries, and because of concerted price support activities by eight Latin American producers (known as the "Bogota Group" or Pan Cafe). The United States refused to negotiate price and quota provisions until this group agreed to cease any further market actions and to liquidate its holdings of physical coffees and futures contracts. Faced with a firm U.S. position and declining prices in late 1980, members of Pan Cafe Agreed to the U.S. conditions. This cleared the way for the reintroduction of quotas in October 1980.

Since the negotiation and implementation of economic provisions, coffee prices generally remained within, or slightly below, the established price range, indicating that the agreement was providing some stability to the coffee market.

We believe the ICA provides benefits to importing members by promoting long-term supply availability through the moderation of price fluctuations. The quotas force exporting members to stock coffee. Also, the system used in the agreement to distribute quotas among exporting members rewards those countries that store coffee. These additional supplies would be available for shipment in the event of an abrupt reduction of output which could result, for example, from a Brazilian frost. Furthermore, I would point out that the price range established by the agreement in which quotas operate is well below average coffee prices in the years prior to the imposition of economic provisions under the agreement.

The foreign policy implications of our continued participation in the ICA are obvious. Coffee is a major export earner in many developing countries, with an annual value in the world trade of around $12 billion. To the extent that the ICA has helped stabilize prices, it has a very positive economic impact on these countries. As the largest single importer of coffee, U.S. participation in the ICA is essential to the functioning of the economic provisions of the agreement.

Coffee is a $3 billion industry in the United States, The industry is made up of importers, traders, brokers, roasters, and retailers. The National Coffee Association, which represents a large segment of the U.S. industry, has indicated that as long as the Government believes the ICA is in the best interest of the United States, it can accept the agreement. Various segments of the industry have cited the need for market stability and believe that the ICA is the best means of achieving this objective.

I would like to reiterate the need to take quick action on this bill. As mentioned earlier, our current legislation expires September 30 of this year. Thus, it is imperative that we have new legislation in place by October 1, 1982, in order to be able to comply with our treaty obligations. Our failure to do so could disrupt the world coffee market significantly to the detriment of both producers and consumers and of our relations with the coffee producing countries of the world.

Again, the legislation we are requesting would enable the United States to continue in the existing agreement for only one more year. The Senate will have the opportunity to carefully examine our continued participation in the agreement during that period, assuming we successfully conclude negotiation of a new agreement.

The International Sugar Agreement (ISA) was originally scheduled to expire on December 31, 1982. A decision was taken by the Council of the International Sugar Organization (ISO) to extend the ISA for two years. Thus, the administration is seeking a two-year extension of legislation implementing the sugar agreement. This legislation gives the President authority to control imports of sugar into the United States to assure that imports are accompanied by the proper documentation and that import restrictions on non-ISO members are enforced.

While we recognize that, owing to the non-membership of the EC, it has proved difficult to operate the economic provisions of the ISA, the administration supports our continued participation in the ISA. We support the two-year extension with the understanding that it will allow time for continued consultations between the ISO and the EC. These consultations are meant to pave the way for EC accession to the current agreement or participation in a new agreement.

In 1977 the United States took the position that an effective ISA could improve security of supply for consumers and still allow for reasonable return to U.S. sugar producers. We sought an agreement which would prevent prices from dropping so low as to discourage production and hence trigger scarcities.

The basic objective of the agreement is to stabilize the price of sugar within an agreed range, set initially at 11-21 cents per pound. The current range is 13-23 cents per pound. The price mechanism provides that when the price indicator is in the lower third of the price range, export quotas are in effect and exporting countries are required to build up obligatory reserve stocks.

The quota mechanism is based upon the assignment to each exporting member of a basic export tonnage (or bet), which has in recent years been determined by export performance. When quotas are in effect, members are required to restrict their exports in accordance with their bet shares. Quota cuts generally do not exceed 15 percent, although when prices are below the price range exports may be cut by an additional 2.5 percent. Exporters who ship in excess of their authorized quota are subject to penalties.

When the price indicator is in the middle third of the price range, there are no quotas in effect and sugar may be freely traded. Near the top of the price range, reserve stocks are required to be released to the market.

Such is the basic outline of the agreement. Compared to previous agreements, the 1977 arrangement is improved in at least three respects. First, the price range was widened to 10 cents per pound from the few cents per pound of earlier agreements. This change was intended to give much greater play to market forces. Except when prices are at the lower end of the range, sugar may be freely traded.

A second change came about because of the insistence of the United States and other importers that quotas must be realistic and based as closely as possible on export performance. Importers also insisted upon an effective shortfall provision. While the initial quota allocation inevitably reflected political bargaining as well as historical performance, the agreement provided for a review and renegotiation of bet's after two years, and if renegotiations did not succeed in establishing an acceptable new bet schedule, bet's are automatically revised in accordance with a formula which gives increasing weight to export performance during the last three years of the agreement.

The third and most important improvement in the agreement was the provision for reserve stocks. Earlier agreements sought to meet the interest of importing members in price protection at the upper end of the range by means of a supply-commitment price. Importers were assured of specific quantities of sugar when prices exceeded established trigger points. Such a provision might have been appropriate when the ISA disposed of less than 50 percent of world sugar trade. But with the breakdown of several preferential arrangements, the greatest part of world traded sugar was thus covered by the ISA and a new approach was needed.

It was because of the insistence of the United States that the reserve stock provision in its present form was added to the agreement. When quotas are in effect, exporting members are required to accumulate 2.5 million tons of sugar in special stocks of uncommitted sugar additional to any supplies held for domestic needs or special arrangements. To assist the exporters in holding such stocks, a fund is provided from which exporters receive interest-free loans to be repaid when stocks are released. The fee which finances the fund currently comes from a levy on the trade which currently amounts to $1.65 per metric ton.

As previously stated, the ISA has not worked as well as expected. For the first two years of the agreement, prices were below the lower end price range objective—I.E., below 11 cents per pound. Prices strengthened late in 1979, but by the spring of 1980, prices exceeded the top of the range and remained there until February of 1981 when they began to ease. As we all know, the decline in price continued to where we are today. World sugar prices are under 10 cents per pound.

While the United States became a provisional member of the agreement at the outset, the United States was unable for some 25 months to comply fully with the agreement. Although this clearly impeded the ability of the ISA to function, it cannot be compared to the problems caused by EC nonparticipation, which has seriously hindered the operation of the agreement.

Using the delay in U.S. ratification as a pretext, the EC ignored repeated requests to discuss with the council possible terms of accession or modifications of its own sugar policy. As a result of its highly protected market, the EC has become one of the world's largest producers of sugar. While it imports a certain quantity of sugar at preferential prices from certain former colonies who are signatories of the Lome Convention, the EC re-exports this sugar and even more of its own heavily subsidized sugar to the world market. We believe that these exports are the single most important factor in the current weakness in the world market. As most of you know, we are currently seeking to reduce the adverse effects of EC subsidy practices both bilaterally as well as in the GATT and the ISA.

Despite its shaky performance, the ISA has been marginally successful in reducing price volatility in the face of conditions of both substantial surplus and shortage. Export quotas in 1978–1979 reinforced market trends leading to a balance between world production and consumption earlier than had supplies not been so restrained. This led to the recovery of world sugar prices that began late in 1979.

The subequent release of over 2 million tons of ISA stocks in February 1980 assisted in preventing world sugar prices from rising to even greater heights later in the year. Indeed, the major reason for prices failing to reach the levels experienced in the previous boom of 1974–75, despite a record global production shortfall in the 1979–80 year, was the persistent and ready availablity of sugar for prompt shipment. This was in part the result of ISA special stock release and also the incentives offered to member exporters under the agreement's quota provisions to maximize shipments during times when quota restrictions do not apply.

It would be irresponsible not to take note of recent actions taken by our own Government in response to current instability in the world sugar economy. In May the President made a decision to impose temporary quotas on sugar imported into the United States. This action was necessitated by the declining world price of sugar and our inability to defend our domestic support price with duties and fees alone. USDA demand estimates required a fairly restrictive quota to help remedy the situation. This has caused some hardship for those exporting countries which had anticipated larger shipments to the United States. As a result we have been asked by ISA exporting members to explain our quota program and we have carried out useful discussions to this effect in London. We have in particular noted that the United States intends to administer quotas, for as long as necessary, in conformity with our obligations under the ISA. However, we believe it is also important that we reaffirm our commitment to working in the ISA to help address the problems of both the world sugar economy in general as well as those of individual sugar exporting countries in Latin America and other regions of the world where we have an important stake in economic and social stability. We urge that S. 2539 be passed quickly. Such action will positively signal our continued support of multilateral efforts in this direction.

I should point out that that portion of the ISA price range in which export quotas operate is substantially below the level at which sugar prices are supported in the United States. Thus, the ISA will not increase U.S. consumer prices for sugar. On the other hand, our failure to meet our treaty obligations under the agreement would tend to put further downward pressure on the already troubled world market for sugar and could result in the imposition of even more restrictive measures on sugar imports.

Senator DANFORTH. Mr. Ambassador, has the administration reviewed these two bills with various interested groups? Is there a process for doing that?

Ambassador MACDONALD. Yes. We have gone through the usual consultation processes, Mr. Chairman, with interested industry groups.

Senator DANFORTH. What is the response of those groups to the bills?

Ambassador MACDONALD. The International Coffee Association says that as long as the U.S. Government believes that the coffee extension bill is in the interest of the United States, it will support that bill.

We have discussed it with all aspects of the sugar industry, and they support the bill.

Senator DANFORTH. Do you know of any domestic opposition to either of the bills?

Ambassador MACDONALD. Nobody on our staff is aware of any. I have not heard of any opposition.

Senator DANFORTH. Is it reasonable to assume that if there were opposition, it would have surfaced?

Ambassador MACDONALD. Yes. Because of our consultation processes established by Congress, we would surface that kind of criticism if it were there.

Senator DANFORTH. And do you believe that each of these bills is in the best interest of the country and both are strongly supported by the administration?

Ambassador MACDONALD. Yes, sir.

Senator DANFORTH. Thank you very much. That concludes the hearing.

[Whereupon, at 9:12 a.m., the hearing was adjourned.]

[By direction of the chairman the following communication was made a part of the hearing record:]

Statement of Consolidated Foods Corporation

on

S. 2540

Subcommittee on International Trade

Committee on Finance

July 28, 1982

Mr. Chairman and members of the Subcommittee on International Trade, I am pleased to offer the views of my company, Consolidated Foods Corporation of Chicago, Illinois, on Senator Danforth's bill, S. 2540, to extend the International Coffee Agreement. My name is Daniel J. Brennan, Vice-President -- Taxes and Insurance, of Consolidated Foods Corporation.

Consolidated Foods Corporation is primarily engaged in providing consumer packaged goods to the public. Overseas subsidiaries of Consolidated Foods are in the business of buying, selling, and distributing coffee. The overwhelming experience has been that the international coffee agreement has had a very beneficial effect on the marketplace. Previously, coffee, like most commodities, was subject to wide swings in the price. These seemingly uncontrolled gyrations in price of course had a very disconcerting effect on sellers and consumers alike. However, since implementation of the International Coffee Agreement, these gyrations have been greatly diminished, both in number and effect. In short, both our subsidiaries and the consumers have benefitted. Consolidated Foods Corporation believes this agreement should be extended and supports S. 2540.

In conjunction with this discussion of the International Coffee Agreement, Consolidated Foods would also like to briefly address a problem in the tax laws concerning the coffee income of these foreign subsidiaries. Specifically, I refer to the anomalous problem addressed in S. 2509 introduced by Senators Percy and Dixon.

Present law -- Under present law, the earnings of foreign corporations owned or controlled by U.S. persons are generally subject to U.S. income tax only when they are actually remitted to the U.S. shareholders as dividends. This procedures is generally referred to as "deferral."

In 1962, in response to a request by President Kennedy, Congress enacted partial repeal of "deferral" in what is commonly referred to as "subpart F" of the tax law. At that time, the President emphasized the removal of tax deferral in the case of what have been called "tax havens." These tax havens were being used by American firms who arranged their corporate structures to significantly reduce or eliminate their tax liabilities both at home and abroad. However, certain of the subpart F rules were adopted in order to meet the problem of diversion of income from U.S. taxation.

There are five categories of income which the Congress decided to tax currently to the U.S. shareholder of a controlled foreign corporation because they fall either into the tax haven category or into situations where there is an attempt to escape tax by shifting U.S. income abroad. These five categories include: 1) income from the insurance of U.S. risks; 2) passive investment income such as dividends, interest, royalties, and rents (referred as foreign personal holding company income); 3) sales income earned by the foreign subsidiary on the sale of property purchased from, or sold to, a related company if the property was neither manufactured in nor sold for use in the country in which the subsidiary is incorporated

(referred to as foreign base company sales income); 4) income from services performed by the foreign subsidiary outside of the country in which it is incorporated (referred to as foreign base company income); and 5) shipping income earned by a foreign subsidiary outside of the country in which it is incorporated, if that income is not reinvested in shipping assets (referred to as foreign base company shipping income).

In considering possible investment income such as dividends to be tax haven type income, the Congress recognized the need to maintain active American business operations abroad on a competitive footing with other operating businesses in the same foreign countries. However, the Congress saw no need to maintain deferral of U.S. tax on income from portfolio investments. But there were a number of exceptions to the rule of taxing foreign personal holding company income.

In 1969, the Code was amended to broaden and clarify one exception. By amending Section 954(b)(4), an item of income received by a controlled foreign corporation was excluded from foreign base company income if both the creation or acquisition of the controlled foreign corporation and the effecting of the transaction giving rise to the income did not have as one of its principal purposes a substantial reduction of income taxes. The rationale behind this exception was that facts and circumstances should sometimes prevail where tax avoidance was not a motivating force in the transaction.

Later, the Tax Reduction Act of 1975 adopted an exclusion to the taxation provisions of subpart F for income arising

from the sale between related parties of agricultural commodities which are not grown in the U.S in commercially marketable quantities. The rationale of that amendment was obviously that since the activity could not have been performed in the U.S. under any circumstances (because the commodities were not grown in commercially marketable quantities here) that no avoidance of U.S. taxation was involved. So, there is a history of granting exceptions where inequities could be shown.

Consolidated Foods Corporation's Operations Abroad -- Consolidated Foods Corporation owns a 65% interest in a company, Douwe Egberts Koninklijke Tabaksfabriek-Koffiebranderijen - Theehandel, B.V., which in incorporated in the Netherlands. Douwe Egberts is a large multi-national company which has been in existence for centuries. To be precies, it was founded in 1753. Consolidated Foods purchased its interest in 1978 in order to quickly penetrate the European markets.

Douwe Egberts trades in consumer products such as tobacco, tea, coffee, spirits, etc. Among its many subsidiaries is a wholly-owned company in Switzerland named Decotrade. It is of interest that Switzerland is one of the major international coffee trading centers of the world. Decotrade is a major international coffee trading operation. It buys from any number of coffee growing companies and sells not only to its sister companies around the world, but also to unrelated parties. The income generated therefrom is exempt from taxation as subpart F income because coffee is not grown in commercially marketable quantities in the U.S. This exemption would apply

whether Douwe Egberts earned the income by performing the coffee trading either through a branch or through a subsidiary in Switzerland. However, if Decotrade, the Swiss coffee trading subsidiary, declares a dividend (from its coffee earnings) to Douwe Egberts, the present U.S. tax law reclassifies the income in Douwe Egberts' hands from that of exempt coffee income to taxable dividend income. This anomaly occurs because dividends, whether from subsidiaries or from unrelated companies, are deemed by the Internal Revenue Code to be foreign personal holding company income. (It should be emphasized that this would not be the case if the company had earned the income through a branch. Additionally, if Decotrade were a branch, the Dutch would not tax the operations, since they are taxed in Switzerland.)

We had been of the opinion, as did our tax counsel, that a dividend from Decotrade to Douwe Egberts would be exempt from subpart F treatment under Section 954(b)(4). The I.R.S. refused to so rule, apparently under the theory that no outside compulsion to pay dividends could be shown. This appears to us to be an unduly restrictive interpretation of the statute. We at Consolidated Foods believe the current interpretation by the I.R.S. produces an inequity, and S. 2509, in essence, redresses that interpretation.

Even if Section 954(b)(4) did not exist, there still would be, in our view, an inequity. Clearly, the form of the transaction is dictating the tax treatment here. This is a violation of the general tax concept that substance should prevail over form.

We should point out that there has been no attempt on our part to move what would otherwise be U.S. income abroad in order to excape U.S. taxation. This income, whether earned directly through a branch or indirectly through a subsidiary, should not be taxed to us under subpart F.

The foreign personal holding company rules were originally included in the subpart F provisions in order to tax passive types of income where that income is not needed in the normal operations of a business. Although the coffee trading income is received by Douwe Egberts as income classified as a dividend, it is not truly passive income not needed in its operations. The coffee trading income, when repatriated to Douwe Egberts, will be retained to be used in its normal business activities. In fact, the Dutch tax authorities insist upon the payment of such a dividend to preclude Douwe Egberts from borrowing to fund its business operations and deducting the interest for Dutch tax purposes. Douwe Egberts is hard pressed to argue that if a dividend is paid, significant tax ramifications occur to its parent under the U.S. subpart F rules. It should be noted that the funds are used, in part, to pay a cash dividend of approximately 40% of earnings, to its shareholders. To sum up, there is no U.S. tax policy being circumvented here, no U.S. tax being avoided, no use of tax havens. Nonetheless, the impact of the law is that Douwe Egberts and Consolidated Foods have been placed in a severe competitive disadvantage in trying to run their European operations.

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We believe that the current situation is inequitable, and that the correction of this situation will not in any way adversely affect the operation of the policies incorporated in subpart F.

Thank you, Mr. Chairman, and members of the Subcommittee for giving me the opportunity to express our views on the International Coffee Agreement and the peculiar effect of the U.S. tax laws on our subsidiaries' coffee income.

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